EU Enlargement

On 1 May 2004, ten countries, including former Communist countries in Central and Eastern Europe, joined the European Union. The countries of the Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia enlarged the EU from 15 to 25 nations. The EU is the second largest market in the world, with a population of 450 million and GDP of $11.65 trillion in PPP terms.

The European Union was formed in 1957 by France, Italy, West Germany, Belgium, the Netherlands and Luxemburg. With the addition of Denmark, the United Kingdom, Ireland, Greece, Spain, Portugal, Austria, Finland and Sweden, there were 15 nations in the EU until 2004. In addition to the 10 accession states, discussions are underway with Bulgaria, Romania and Turkey.

Why do countries aim to join the EU? Well, the reasons are varied but for the 10 new accession states, they are largely economic and political. For most of the newly acceded states except for Malta, they are former communist states who wished to rejoin Europe and overhaul their political and institutional structures. For Western Europe, the post-Cold War view of Europe includes eastern expansion. The delay that had come about was a result of economic considerations.

For both the new states and old Europe, EU enlargement is driven by cost and benefit considerations. The new accession states are much poorer than the EU15, as per capita income in those countries is about one-third of that of Western Europe. The population of the new accession states is also less than one third of that of Western Europe. Given the dramatic differences in size and wealth, it is clear that the new accession states can expect significant gains from integration. Moreover, more than half of all exports from the new accession states go to the EU15, which makes the market a critically important one for these nations. Economic integration will allow these nations to trade with a richer, higher cost EU15 which had a large domestic market of 369 million people before enlargement.

For the EU15, the gains as a percentage of GDP may be lower. For instance, only 4% of all exports from the EU15 go to the new accession states.
But, it gains access to a source of low cost labour and a younger population which can revitalise the ageing work force in old Europe. Moreover, there will still be efficiency and welfare gains from reducing trade frictions.

When measuring the benefits of economic integration, there are six types of effects to consider. The first is the *trade creation effect* which derives from trade volume changes. This is when an imported good is cheaper than the domestic good. Trade can then lower prices and increase economic welfare. The second stems from trade price changes. When the imported goods are cheaper than domestic goods, then consumers benefit while producers lose out and *trade diversion* could occur because producers will switch to cheaper foreign suppliers. The supply switching part of the trade diversion effect could increase welfare. And, there is a third effect which is known as *trade rents*, which refers to the revenue that arises when a firm sells across a border when there are high domestic prices and low import prices. With economic integration, welfare and efficiency will be improved because trade rents will fall. These three effects are associated with perfectly competitive markets. When imperfectly competitive markets are considered, there are an additional set of effects to consider, that is, *producer profit effects, scale effects, and variety effects*. Profit and scale effects refer to the lower of costs with economic integration that can allow producers to increase profits and realise economies of scale. The variety effects refer to the increase in diversity of goods which benefit consumers. Finally, in addition to these allocation effects, there are also accumulation effects from economic integration. Whereas the six effects that have been described relate to better allocation of existing factors in an economy, the accumulation effect refers to the gains to total GDP which can occur with economic integration.

When these effects are considered, the arguments in favour of EU enlargement look strong. However, there are costs as well. The economic ones relate to budgetary transfers on account of the wealth differential between the EU15 and the new accession states. The other costs are political and bureaucratic in that decision-making will become more drawn out and the chances of gridlock are increased due to the different stages of development of these countries.

However, in weighing the costs and benefits, EU enlargement has significant benefits which have driven the accession of the 10 new states and are fuelling the interest of others. The current debate, though, will also focus on the euro as the new accession states will need to consider the costs and benefits of a single currency now that they have joined the Single Market.